NO. 11980

In the United States Court of Appeals for the Ninth Circuit

WILSON BROS. & CO., *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Petition for Review of the Decision of the Tax Court of the United States

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BRIEF FOR THE RESPONDENT

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OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 30-47) are reported in 10 T. C. 251.

JURISDICTION

This proceeding, as to the single issue on appeal, involves deficiencies in federal personal holding company surtax and penalties for the calendar years 1938 to 1942, inclusive. (R. 48.) On May 29, 1946, the Commissioner of Internal Revenue mailed to the taxpayer a notice of deficiency in taxes. (R. 9.) On August 20,

1946 (R. 2), within ninety days thereafter, the taxpayer filed a petition (R. 4-28) with the Tax Court of the United States for a redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code. The final order and decision of the Tax Court finding deficiencies in tax was entered on May 18, 1948. (R. 48.) The case is brought to this Court by a petition for review (R. 48-50) filed June 30, 1948 (R. 50), pursuant to the provisions of Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Did the Tax Court err in holding that, for the purpose of computing the personal holding company surtax, the taxpayer, a personal holding company, was not entitled to deduct, under the provisions of Section 505 (b) of the Internal Revenue Code, certain amounts claimed on account of depreciation and expenses of two boats during the taxable years 1938 to 1942, inclusive?

STATUTE INVOLVED

The applicable statute is set out in the appendix, *infra*.

STATEMENT

Relevant to the single issue on appeal, the facts as found by the Tax Court (R. 33-38) are as follows:

Wilson Bros. & Company, the taxpayer, is a Nevada corporation with its principal office at San Francisco, California. It filed its tax returns on the accrual basis. During the years 1938 to 1942 the corporation was a personal holding company. (R. 33.)

The corporation was organized in December, 1928, by W. T. Wilson and F. A. Wilson, each of whom paid $500 for one-half of its capital stock of $1,000, represented by forty shares, and thereafter they jointly con-

tributed to paid-in surplus $624,000 and two schooners, the "Oregon" and the "Idaho". Each has since owned twenty shares. The brothers were successfully engaged as partners in the milling, shipping, and selling of lumber on the west coast of the United States. They operated logging camps and sawmills, manufacturing lumber in Washington and shipping it on the two schooners for sale in San Francisco, Los Angeles, and San Diego. The business was begun by their grandfather and continued by their father, and they participated in it from early youth. After 1928 it was conducted by the corporation. The schooner "Oregon", in which the brothers owned a one hundred per cent interest, and the schooner "Idaho", in which they owned a seventy-five per cent interest, were transferred to the corporation at a value of $175,000. As an additional contribution to paid-in surplus, the brothers on March 20, 1931, transferred to the corporation a bank account of $480,372.24, which they had received as a gift from their mother. At the time of this transfer it was orally agreed between them that either might at any time make withdrawals not exceeding $150,000 from the corporation and repay the amounts without interest when convenient to the drawer or necessary for the corporation's business. (R. 33-34.)

With the cash contributions of the brothers, the corporation purchased stocks, principally of domestic corporations. In 1938 and succeeding years its security holdings exceeded $800,000 in value, and it derived over eighty per cent of its income from dividends. F. A. Wilson, its president and general manager, and W. T. Wilson, its secretary and treasurer, gave attention to its investments. During the taxable years they followed market reports, made some slight changes in holdings, exercised rights, and once purchased stocks with the proceeds of some matured bonds. F. A. Wilson had

charge of maintaining and repairing the two schooners, which were not in use, of finances and collections, and the preparation of tax returns. He and his brother were both active in seeking a purchaser or lessor for the schooners, and in 1939 he made an unsuccessful trip to the northwestern states in search of lumber. He was a member of the San Francisco Stock Exchange and operated a brokerage business. He also looked after his personal security portfolio, containing stocks of a value of about $200,000. W. T. Wilson kept the corporation's accounts. He also engaged in a retail lumber business at Los Angeles, which he took over from the corporation in 1938 and from which he reported gross income of $184,000 in 1939, $127,000 in 1940, and $187,000 in 1941. He engaged a manager at $300 a month for this business. In 1938 the corporation ceased to deal in lumber, and its only business was the care of investments and the collection of dividends and a small amount of rent. (R. 35-36.)

The two schooners which were transferred to the corporation were wooden-hull boats of 1,800 tons dead weight, with cargo space for 1,200,000 board feet of lumber. After being operated by the corporation for a part of the year 1929, they were "laid up" because a lull in the lumber market left taxpayer with large unsold stocks on hand. For some years thereafter the brothers expected to put the boats back into service, to ship lumber in them again when market conditions should improve. But in succeeding years such conditions grew worse, and the boats have never been used. They have been kept moored, however, under the care of a watchman, who cleans and paints the superstructure, and at intervals of 15 to 18 months they are placed in drydock for general overhauling, caulking and repairs. While not seaworthy since 1929, they have been maintained in such a condition that they could be made so within a period of sixty to ninety days. (R. 37.)

In 1938, W. T. Wilson took over individually a retail branch of the corporation's business, selling pine to motion picture studios and others from the office and lumber yard which the corporation formerly used. Since that year the corporation has not dealt in lumber or derived any income from its sale. During the years 1938 to 1942, numerous efforts were made to sell or lease the boats; some offers were received, but not accepted. Being of wood, the schooners are inferior to ships having steel hulls and cannot be as readily leased or sold. During the war they were not desired by the Maritime Commission because they were slow and small. (R. 37-38.)

For the years 1938 to 1942, the following amounts were claimed and allowed for income tax purposes as depreciation and expenses connected with the boats (R. 38):

Year	Total	Depreciation	Expenses
1938	$12,459.96	$10,002.08	$2,457.88
1939	15,094.35	10,002.08	5,092.27
1940	15,028.68	10,002.08	5,026.60
1941	16,166.87	10,002.08	6,164.79
1942	12,898.05	10,002.08	2,895.97

The above amounts were not allowed as deductions in the determination of the corporation's personal holding company surtax. The corporation received no rent or other compensation for the use of the boats in 1938, 1939, 1940, 1941, and 1942. The boats were not held in the course of the corporation's business in those years, and were not necessary for the conduct of that business. (R. 38.)

The Commissioner determined deficiencies in personal holding company surtaxes and penalties (R. 32) which amounts were redetermined and substantially re-

duced by the Tax Court (R. 48). The taxpayer petitions for a review of that decision in so far as it relates to the disallowance of a deduction for depreciation and expenses of the boats during the tax years for the purpose of computing the personal holding company surtax. (R. 48-51.)

SUMMARY OF ARGUMENT

The Tax Court properly held that the taxpayer was not entitled to the deductions claimed for depreciation and expenses of two boats in computing the personal holding company surtax net income. During the taxable years, the taxpayer was admittedly a personal holding company within the definition of Section 501 of the Internal Revenue Code. The Tax Court so found and no error is alleged in that regard which would put that question in issue on appeal.

Since the taxpayer is a personal holding company we must look to subchapter A relating to personal holding companies to determine what deductions are allowable in computing the taxable net income.

Since the corporation derived no income, during the taxable years, from the boats it is only entitled to a deduction for expenses and depreciation if it proved that it met the three conditions precedent prescribed by Section 505 (b) of the Internal Revenue Code. The specific limitations prescribed by that section are necessarily controlling over the general provisions allowing a deduction for expenses and depreciation under Section 23 (a) and (1) of the Internal Revenue Code.

A review of the facts and findings of the Tax Court show that the taxpayer did not meet the three requirements of Section 505 (b). It did not establish (1) that rent or other compensation were not obtainable for the boats; (2) that the boats were held in the course of a business carried on *bona fide* for profit; or (3) that

there was reasonable expectation that the operation of the boats would result in a profit or that the boats were necessary to the conduct of the business. In the absence of such a showing the provisions of Section 505 (b) of the Internal Revenue Code deny any allowance for expenses and depreciation in computing personal holding company surtax net income.

An analysis of the taxpayer's arguments shows that they are not germane to the issue involved.

ARGUMENT

I

The Tax Court Properly Held That the Taxpayer was Not Entitled to a Deduction for Depreciation and Expenses of Two Boats in Computing the Personal Holding Company Surtax

During the taxable years, the taxpayer was admittedly a personal holding company within the definition of Section 501 of the Internal Revenue Code (Appendix, *infra*). The Tax Court so found (R. 33) and no error is alleged in that regard which would put that question in issue on appeal (R. 50-51).[1]

Since the taxpayer is a personal holding company we must look to subchapter A relating to personal holding companies to determine what deductions are allowable in computing the taxable net income.

Section 505 (b) of the Internal Revenue Code (Appendix, *infra*) limits the general deductions for ex-

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[1] Furthermore, if there are deficiencies in personal holding company surtaxes, there can be no question as to the imposition of penalties and no error is alleged in that regard. The taxpayer failed to file personal holding company surtax returns for the years in which a penalty was imposed. This is admitted by the petition for review (R. 49) and no reasonable cause for such failure is shown by the record. The imposition of the penalties was therefore mandatory under Section 291 of the Internal Revenue Code. *Commissioner* v. *Lane-Wells Co.*, 321 U. S. 219, 224.

penses and depreciation, accorded by Section 23 (a) and (1) of the Internal Revenue Code, to an amount equal to rent or other compensation from the property affected unless it is established (under regulations prescribed by the Commissioner with the approval of the Secretary)[2] to the satisfaction of the Commissioner that three concurrent conditions exist, namely: (1) That the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable; (2) that the property was held in the course of a business carried on bona fide for profit; and (3) either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

Since the corporation derived no income during the taxable years from the boats, it is only entitled to the deductions claimed if it proves that the above three conditions are fulfilled in respect to them.

The Commissioner having determined in the first instance, in accordance with the express terms of the statute, that the taxpayer had not met the conditions prescribed, the burden before the Tax Court was upon the taxpayer to prove that it came within the requirements of the taxing statute. In that it failed.

The necessity for compliance with the requirements of Section 505 (b) are discussed at some length in *Monroe, Inc.* v. *Commissioner,* decided September 7, 1943 (1943 P-H T. C. Memorandum Decisions, par. 43,413). In that case the Tax Court held that the mere holding of property for sale did not fulfill the requirements of the statute and said:

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[2] See Section 19.505-1 of Treasury Regulations 103, promulgated under the internal Revenue Code. This is substantially the same as Article 406-1 of Treasury Regulations 101, promulgated under the Revenue Act of 1938.

> The very fact that this proceeding is before us shows that the petitioner has not satisfied the respondent that it is entitled to the deduction under section 505 (b), *supra,* and regulations issued thereunder. Thus the respondent's determination must be sustained unless his denial of the deductions was arbitrary and an abuse of discretion. *Stranahan* v. *Commissioner,* 42 F. (2d) 729, certiorari denied, 283 U. S. 822; *Olympia Harbor Lumber Co.* v. *Commissioner,* 79 F. (2d) 394; *Connery Coal and Investment Co.* v. *Commissioner,* 84 F. (2d) 485; *First Securities Corporation of Memphis, Tennessee* v. *Clements,* 103 F. (2d) 1011; *Western Hide & Fur Co.,* 26 BTA 354; *Walter H. Goodrich & Co.,* 40 BTA 960.

It is obvious, under well-established rules of construction, that the specific limitations of Section 505 (b) are controlling over the general provisions for the allowance of expenses and depreciation under Section 23 (a) and (1) of the Internal Revenue Code.[3] Therefore, the issue is narrowed to whether the taxpayer satisfies the conditions of Section 505 (b) and no other. Congress has laid down the pattern and the taxpayer must show that it comes within the conditions prescribed since the courts may not by probing into tax motives undertake to relieve from the harshness of a particular application of the statute. *Commissioner* v. *Affiliated Enterprises,* 123 F. 2d 665, 667 (C. C. A. 10th), certiorari denied, 315 U. S. 812; *O'Sullivan Rubber Co.* v. *Commissioner,* 120 F. 2d 845, 848 (C. C. A.

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[3] Note also that Section 505 (c) of the Internal Revenue Code denies a net loss carry-over and Section 505 (d) denies a capital loss carry-over in computing the net income of personal holding companies although general provisions of the tax laws allow those deductions.

2d). In the above cases the courts held that a corporation falling within the definition of a personal holding company is taxable as such despite the absence of a tax avoidance motive.

As to fulfilling the first requirement of Section 505 (b) of the Internal Revenue Code, it is apparent that the taxpayer failed to show that no rent or other compensation "was obtainable" for the boats during the tax years in question. On the contrary, it was admitted by the brothers that offers to buy or lease the boats were received. (R. 37.) There was no explanation of the reasons for refusing all of these offers. (R. 44.) Admittedly the boats could have been made seaworthy although not in use. (R. 37, 44.) But there was no showing that some income might not have been derived from the boats. The mere fact that no rent or other compensation was received or that attempts to rent were unproductive because the parties interested would not meet taxpayer's terms fails to establish that no rent was obtainable during the taxable years from the property within the meaning of Section 505 (b)(1) of the Internal Revenue Code.

As to fulfilling the second requirement of Section 505 (b) of the Internal Revenue Code, it is also apparent that the boats were not held in the course of a business carried on *bona fide* for profit. Since the taxpayer ceased to deal in lumber in 1938 and the boats were not in active use from 1929 they were not held in the course of the taxpayer's business during the taxable years nor were they necessary to the conduct of its business. The Tax Court so found. (R. 38, 41.)

In 1938 the taxpayer discontinued its lumber business. (R. 45.) The fact that the boats were tied up since 1929 would indicate that they were not held in the course of that business, and obviously they were not

held in the course of any other business carried on by the taxpayer.

In 1938 and subsequent years the assets of the taxpayer consisted almost entirely of securities of a market value in excess of $800,000. (R. 41, 45.) Certainly such evidence fails to support any conclusion that the boats were held in the course of a business carried on *bona fide* for profit within the meaning of Section 505 (b)(2) of the Internal Revenue Code.

Since the requirements of Section 505 (b) are in the conjunctive, the failure of the taxpayer to meet the conditions prescribed in subdivisions (1) and (2) are a sufficient basis for denying its claims for expenses and depreciation. But with respect to fulfilling the third requirement of Section 505 (b), the record fails to show that there was a reasonable expectation that operation of the boats would result in a profit, or that they were necessary to the conduct of the business.[4] The Tax Court found that they were not. (R. 38.) The fact that the boats were tied up since 1929 and were in an unseaworthy condition during the taxable years resolves these requirements against the taxpayer. Until such time as the boats could be operated there could be no reasonable expectation that they could be operated at a profit. The fact that by extensive repairs these boats might have been placed in an operating condition is immaterial. The fact remains that the taxpayer was not engaged in the shipping business during the taxable years and the record is silent as to how the boats were necessary to any business conducted by the taxpayer in the taxable years.

Unless the Commissioner's action in disallowing the deduction here claimed is arbitrary or amounts to an abuse of discretion it must be sustained. That was the

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[4] The latter provision is answered in part in connection with the discussion of failure to meet the second requirement of the statute.

holding in *Monroe, Inc.* v. *Commissioner, supra,* and cases cited in the quotation therefrom above. We submit that the evidence fails to show that the Commissioner's denial of the claimed deductions was arbitrary or an abuse of discretion, and the affirmance of his action by the Tax Court is in accordance with law.

II

The Taxpayer's Arguments are Not Germane to the Issue Involved

The taxpayer (Br. 11-19) sets out *in extenso* the legislative history relating to personal holding companies. Seemingly, the purpose is to show that the taxpayer's business was not one intended by Congress to be subjected to the personal holding company provisions because it was not an "incorporated family pocketbook". (Br. 28-40.) But admittedly the taxpayer was a personal holding company within the definition of Section 501 of the Internal Revenue Code as to stock ownership and its income was derived from the sources, dividends, interest and rent (R. 35-36), as specified in Section 502 (a). During the taxable years its assets consisted almost entirely of securities of a value in excess of $800,000 and as to the two brothers it was in effect their incorporated pocketbook. (R. 41, 45.)[5]

Similar arguments, that a company was not within the spirit and substance of the legislation, were made when the first personal holding company cases came before the courts. These arguments were rejected on the ground that motive was immaterial if the company otherwise satisfied the provisions of the statute. The whole situation is well summed up in *O'Sullivan Rub-*

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[5] It should be noted that neither in the petition to the Tax Court (R. 4-9) nor in errors assigned in this Court (R. 50-51) does the taxpayer put in issue the question of its status as a personal holding company.

ber Co. v. *Commissioner,* 120 F. 2d 845 (C. C. A. 2d), where the court said (pp. 847-848):

> But, urges the petitioner, the personal holding surtax was enacted to remedy the evil of the "incorporated pocket book," deliberately created to reduce the personal taxes of those who created them, and, therefore, to impose the tax upon a corporation in petitioner's position is a perversion of the Congressional purpose. We may assume that the taxpayer here was not deliberately aiming to relieve its stockholders from personal taxation. It is, however, abundantly clear that Congress, in correcting an evil, is not narrowly confined to the specific instances which suggested the remedy. "Of course, all personal holding companies were not conceived in sin—many were organized for legitimate personal or business reasons; but Congress has made little distinction between the goats and the sheep". In enacting the very section being applied here, Congress was attempting to foreclose the defense, available under section 104 of the Revenue Act of 1932, 26 U. S. C. A. Int. Rev. Acts, page 509, that the accumulation of profits was responsive to a legitimate business need. See Committee on Ways and Means, 73d Cong., 2nd Sess., House Report No. 704, p. 12: "The effect of this system * * * is to provide for a tax which will be automatically levied upon the holding company without any necessity for proving a purpose of avoiding surtaxes." Cf. Committee on Finance, 73d Cong., 2nd Sess., Senate Report No. 558, p. 15. * * * Having before us indisputable proof from the exactitude of Section 351 itself, reinforced by the Committee reports, that Congress wished to establish objective criteria for imposition of the tax, we cannot, by probing into corporate motives, undertake to re-

lieve from the alleged harshness of a particular application of the statute.

We must therefore assume for purposes of this appeal that the taxpayer was taxable as a personal holding company as found by the Tax Court. (R. 33.)

The taxpayer argues (B. 24-25) that the deductions for expenses and depreciation would be allowable if the boats had been held by an individual. That is beside the point because the boats were in fact owned by the corporation, a personal holding company, and allowance of the deductions therefor depends on whether the requirements of Section 505 (b) of the Internal Revenue Code have been met.[6] In this connection the taxpayer relies upon the amendment of Section 23 allowing to an individual a deduction for non-trade or non-business expenses. But the amendment is confined to an "*individual*" and does not apply to a corporation. The statute is specific.[7]

The taxpayer argues (Br. 26-28) that Section 23 and Section 505 should be integrated for tax purposes. Such

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[6] It is immaterial that the Tax Court may have given a wrong reason in reaching a correct decision. *Helvering* v. *Gowran,* 302 U. S. 238, 245-246.

[7] The amendment reads (Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798):

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
> In computing net income there shall be allowed as deductions:
> (a) *Expenses.*—
>
> * * * * * *
>
> (2) *Non-trade or non-business expenses.—In the case of an individual,* all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. (Italics supplied.)

an argument ignores the fact that, for purposes of the surtax, a personal holding company must first satisfy the requirements of Section 505 (b) before a deductible allowance for expenses and depreciation can be made under Section 23 of the Internal Revenue Code.[8] The specific statute, Section 505 (b), is controlling over the general provisions of Section 23. See our discussion of this point under Argument I, *supra.*

CONCLUSION

On the record made, the decision of the Tax Court is in accordance with law and should therefore be affirmed.

Respectfully submitted,

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October, 1948.

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[8] It should be noted that for income tax purposes the taxpayer was allowed a deduction for expenses and depreciation of the boats for the taxable years. (R. 38.)

APPENDIX

Internal Revenue Code:

SUBCHAPTER A—PERSONAL HOLDING COMPANIES

SEC. 500. SURTAX ON PERSONAL HOLDING COMPANIES.

There shall be levied, collected, and paid, for each taxable year beginning after December 31, 1938, upon the undistributed subchapter A net income of every personal holding company (in addition to the taxes imposed by chapter 1) a surtax equal to the sum of the following: [Here follow scheduled rates.] (26 U. S. C. 1946 ed., Sec. 500.)

SEC. 501. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) *General Rule.*—For the purposes of this subchapter and chapter 1, the term "personal holding company" means any corporation if—

(1) *Gross income requirement.*—At least 80 per centum of its gross income for the taxable year is personal holding company income as defined in section 502; but if the corporation is a personal holding company with respect to any taxable year beginning after December 31, 1936, then, for each subsequent taxable year, the minimum percentage shall be 70 per centum in lieu of 80 per centum, until a taxable year during the whole of the last half of which the stock ownership required by paragraph (2) does not exist, or until the expiration of three consecutive taxable years in each of which less than 70 per centum of the gross income is personal holding company income; and

(2) *Stock ownership requirement.*—At any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

* * * * *

(26 U. S. C. 1946 ed., Sec. 501.)

SEC. 505. SUBCHAPTER A NET INCOME.

* * * * *

(b) *Deductions Not Allowed.*—The aggregate of the deductions allowed under section 23 (a), relating to expenses, and section 23 (1), relating to depreciation, which are allocable to the operation and maintenance of property owned or operated by the corporation, shall be allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established (under regulations prescribed by the Commissioner with the approval of the Secretary) to the satisfaction of the Commissioner:

(1) That the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;

(2) That the property was held in the course of a business carried on bona fide for profit; and

(3) Either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

* * * * *

(26 U. S. C. 1946 ed., Sec. 505.)

Substantially the same provisions as above are contained in the Revenue Act of 1938, c. 289, 52 Stat. 447, Sections 401, 402 and 406.

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